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**BEFORE THE
CALIFORNIA BOARD OF ACCOUNTANCY
DEPARTMENT OF CONSUMER AFFAIRS
STATE OF CALIFORNIA**

In the Matter of the Accusation Against:

Case No. AC-2004-34

Ernst & Young LLP
Attn: Anthony K. Anderson
725 South Figueroa Street, Fifth Floor
Los Angeles, California 90017

ACCUSATION

CPA Partnership Registration
No. PAR 5413,

Respondent.

Carol Sigmann, the Complainant herein, alleges:

PARTIES and JURISDICTION

1. The Complainant herein, Carol Sigmann, brings this Accusation under Business and Professions Code section 5100 solely in her official capacity as the Executive Officer of the California Board of Accountancy, Department of Consumer Affairs ("Board").

2. On or about December 1, 1989, the Board issued CPA Partnership Registration No. PAR 5413 to Ernst & Young to practice public accountancy as a partnership in the State of California pursuant to the California Accountancy Act (Division 3, Chapter 1, Section 5000 et

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1 seq. of the California Business and Professions Code). On September 26, 1994, the Board
2 approved a request to change the name on the registration to Ernst & Young LLP.² The
3 registration was in full force and effect during the time periods relevant herein and is renewed
4 through December 31, 2005.

5 3. This Accusation is brought before the Board under the authority of section 5100
6 of the Business and Professions Code,³ which provides, in relevant part, that, after notice and
7 hearing the board may revoke, suspend or refuse to renew any permit or certificate granted, for
8 unprofessional conduct which includes, but is not limited to, one or any combination of the
9 causes specified therein, including pertinent provisions of subparagraphs of section 5100, as
10 follows:

1 5100(g) Willful violation of the Accountancy Act or any rule or regulation
12 promulgated by the Board.

13 5100(h) The suspension or revocation of the right to practice before any
14 governmental body or agency.

15 5100(l) The imposition, by the United States Securities and Exchange
16 Commission, of any discipline, penalty, or sanction on a registered public

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20 1. In or about December 1989, Arthur Young & Company, which had been licensed under California
21 Certified Public Accountant Partnership Registration No. PAR 147, merged with Ernst & Whinney, to form the
22 successor partnership, Ernst & Young. Arthur Young & Company surrendered Partnership Registration No. PAR
23 147 pursuant to the Board's adoption, on April 25, 1991, of the Stipulation for Settlement and Decision in
24 Accusation No. AC-91-12, that is, the Accusation Against Arthur Young & Company (and Francis Joseph
25 O'Brien, CPA) in re: the Arthur Young audits of Lincoln Savings & Loan and American Continental Corporation.
26 Ernst & Young, as the successor licensed partnership, undertook the performance of the actions described in the
27 Stipulation. Ernst & Young agreed, *inter alia*, to maintain, and to comply with, its promulgated internal policies
28 and procedures regarding, among other things, Consultation, the Documenting of Conclusions, and the Resolution
of Differences of Professional Opinion. Ernst & Young also agreed to further its policies regarding independence
and professional skepticism (specifically regarding employment of Ernst & Young auditors by audit clients).
Paragraph 18 of the Decision provides that, in any subsequent proceeding by the Board against Respondent Ernst
& Young, the Board, in determining the appropriate discipline, may take into account the terms of the Stipulation.

27 2. "Ernst & Young" or "EY" when used herein refers to both Ernst & Young and Ernst & Young LLP.

28 3. All statutory references are to the Business and Professions Code unless otherwise indicated.

accounting firm or on any other holder of a permit, certificate, license, or
other authority to practice in this state.

4. Code section 5101 provides, *inter alia*, that a partnership permit may be disciplined for any of the causes enumerated in Code section 5100.

5. Board Rule 65 (Title 16, Cal. Code Regs., § 65) requires that a licensee be independent in the performance of services in accordance with professional standards.

6. Code sections 118(b) and 5109 provide in pertinent part that the suspension, expiration, cancellation, or forfeiture of a license issued by the Board shall not, deprive the Board of its authority to investigate, or to institute or continue a disciplinary proceeding against, a licensee upon any ground provided by law, or to enter an order suspending or revoking the license or otherwise taking disciplinary action against the licensee on any such ground.

7. Code section 5000.1 provides as follows: "Protection of the public shall be the highest priority for the California Board of Accountancy in exercising its licensing, regulatory, and disciplinary functions. Whenever the protection of the public is inconsistent with other interests sought to be promoted, the protection of the public shall be paramount."

FIRST CAUSE FOR DISCIPLINE

Suspension of Right to Practice Before a Governmental Body or Agency [Business and Professions Code § 5100(h)]

8. Respondent's partnership registration is subject to disciplinary action under section 5100(h) pursuant to an Order entered by the United State Securities and Exchange Commission ("SEC" or "Commission"). The facts and findings are summarized below.

The Commission's Order

9. The Order⁴ entered by the United State Securities and Exchange Commission ("SEC" or "Commission") on April 26, 2004, in its case *In the Matter of Ernst & Young, LLP*

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4. The order is captioned *Order Granting Motion for Expedited Entry of Final Order and Notice That Initial Decision Has Become Final*.

(Administrative Proceeding File No. 3-10933⁵) represented the final resolution of the Commission's case against Ernst and Young LLP concerning independence violations with which Ernst & Young had been charged in connection with its audit client, PeopleSoft Inc. ("PeopleSoft"), a provider of software applications that assist companies in managing business activities.

10. The Order was entered by the Commission in response to a joint motion of Respondent Ernst & Young LLP and the SEC's Division of Enforcement and Office of the Chief Accountant. The parties' motion requested the expedited entry of an order making final the Initial Decision of SEC Chief Administrative Law Judge Brenda P. Murray ("ALJ Murray"), issued on April 16, 2004. The Commission adopted that decision and the order contained therein as its final decision in the matter. Certain findings set forth in the decision, and the Order, are summarized below.

11. The Initial Decision (Initial Decision Release No. 249; Administrative Proceeding File No. 3-10933 *In the Matter of Ernst & Young LLP*) followed eleven days of public hearings which took place in March and April 2003. The findings set forth hereinafter are derived from that Decision and have been made final by the Commission as set forth above.

12. The Commission found that Ernst & Young was not independent in fact and appearance when it audited the financial statements of PeopleSoft for fiscal years ended December 31, 1994, through the year ended December 31, 1999. The Commission found violations arising out of Ernst & Young's business relationships with PeopleSoft, involving Ernst & Young's Global Expatriate Management System (EY International Tax Group) and/or actions by Ernst & Young's Consulting Group, created an identity or mutuality of interests, as follows:

a. EY/GEMS (including licensing and distribution agreement). Ernst & Young was auditing PeopleSoft's books at the same time that its *International Tax Group* had business relationships with PeopleSoft, including an Application Software partnership through which EY entered a licensing and distribution agreement with PeopleSoft in connection with its

5. The Order is also filed as Securities Act of 1933 Rel. No. 8413; Securities Exchange Act of 1934 Rel. No. 49615; and Accounting and Auditing Enforcement Rel. No. 1991.

1 development of "EY/GEMS"⁶ and its interface with PeopleSoft's software application "HRMS"
2 (human resources management systems). During their relationship, EY licensed a total of three
3 copies of EY/GEMS for PeopleSoft, paying PeopleSoft royalties totaling \$300,000.00, and
4 technical support and maintenance payments totaling \$75,000.00.⁷ EY marketed EY/GEMS for
5 PeopleSoft as a joint product, and it did so at PeopleSoft User Conferences.

6 The Commission found that Ernst & Young's actions in connection with EY/GEMS
7 "established a direct business relationship" in the form of a joint product. EY's direct business
8 relationship with People Soft relative to EY/GEMS for PeopleSoft violated auditor independence
9 requirements, and that EY was not acting as a consumer in the normal course of business.

10 b. Implementation Activities. Ernst & Young was auditing PeopleSoft's books at
1 the same time that its *Consulting Group* had an Implementation Partnership⁸ with PeopleSoft.
12 The Commission found that EY and PeopleSoft had a "symbiotic relationship," engaging in
13 joint sales and marketing efforts, and sharing considerable proprietary, confidential business
14 information, and that EY partnered with PeopleSoft to the maximum extent possible to
15 accomplish sales and boost EY's consulting revenues.⁹

16 The Commission found that the 1993 and 2000 Implementation Agreements created a
17 direct business relationship between EY and PeopleSoft, and that EY's implementation activities
18 on behalf of third parties created a material indirect business relationship between EY and
19 PeopleSoft. The Commission found that EY's activities "went too far" and established "a
20 continuing relationship for the mutual benefit of the two parties and created such an identity or
21 mutuality of interests between EY and PeopleSoft that a reasonable investor would believe that
22 EY would not be objective in auditing PeopleSoft's financial statements." Among the proscribed

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24 6. "GEMS" stands for Global Expatriate Management System.

25 7. EY earned \$767,500 from licensing fees for EY/GEMS for PeopleSoft in fiscal years 1998 through 2001.

26 8. From fiscal year 1995 through fiscal year 1999, Ernst & Young earned approximately \$425 million from
27 implementing PeopleSoft software for third parties.

28 9. In 1998, EY earned \$150 million from implementing PeopleSoft software and \$372,000 from auditing
PeopleSoft's financials.

conduct was “joint marketing and joint sales activities that occurred across the board.” This conduct violated auditor independence requirements.

13. The Commission further found that the overwhelming evidence was that EY’s day-to-day operations were profit-driven and ignored considerations of auditor independence in its business relationships with PeopleSoft. The Commission found that, in issuing Ernst & Young’s audit reports for the respective six years, Ernst & Young’s lead audit engagement partner Richard L. Frick¹⁰ certified that Ernst & Young was independent, and that each audit (FYE’s 1994 through 1999) was conducted in accordance with Generally Accepted Auditing Standards (“GAAS”), whereas Ernst & Young was not independent as required by GAAS. Charged with signing EY’s audit reports in 1995 through 2000, Mr. Frick did not know, or ignored evidence showing that, EY had improper business relationships with PeopleSoft arising from its licensing activities with EY/GEMS for PeopleSoft and from its software implementation activities.

14. Regarding EY’s approach to compliance with independence rules, the Commission found that:

a. Ernst & Young did not have, and was not putting in place, policies and procedures that could reasonably be expected to deter violations and ensure compliance with the rules on auditor independence with respect to business dealings with audit clients. Ernst & Young personnel had access to “Guidelines” consisting of informal independence guidance but the guidelines were not adopted by Ernst & Young, and much of Ernst & Young’s conduct in the PeopleSoft engagements was contrary to those guidelines. Ernst & Young relied more on a “culture of consulting” than on written guidelines. Further, firm guidelines/policies (e.g., “Engagements in Association with Clients” and “Management Consulting Engagement and

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10. Mr. Frick was also Ernst & Young’s coordinating partner for the client, PeopleSoft, from the fall of 1995 until June 2000. As the coordinating partner, Mr. Frick was responsible for overseeing all EY services provided to PeopleSoft, and was expected to have a comfort level that all business relationships did not raise independence concerns before signing the audit report. He was not responsible for overseeing the implementation services that EY provided to third persons. Mr. Frick’s office was in San Jose, California.

1 Client Acceptance”) were not observed. Control systems, training, and supervision were
2 inadequate.

3 b. Edmund Coulson¹¹ was Ernst & Young's senior person on independence
4 issues since 1991, and was consulted on potential PeopleSoft independence issues. In 1994, EY
5 had never entered an agreement that was similar to the Licensing Agreement. Mr. Coulson had
6 not previously encountered the issue of whether an auditor could pay a royalty to its audit client
7 without violating independence standards. He conducted no independent research on this issue,
8 and he knew of no other situation where EY made a royalty payment to an audit client. Mr.
9 Coulson was unaware of any other agreement: (1) making an audit client the beneficiary of an
10 agreement the auditor entered with a third party; (2) giving an audit client control over product
11 quality; (3) where an audit client helped set the fees that its auditor charged third parties; and (4)
12 where an auditor paid an audit client a quarterly technical support fee during product
13 development. He did not read the proposed Licensing Agreement, but approved it based on two
14 or three phone conversations. He kept no logs or any other written record of the independence
15 advice that he provided to Ernst & Young professionals. There was no evidence that anyone in
16 EY sought Mr. Coulson's advice on any independence issue that arose from EY's consulting
17 (implementation) activities or that EY complied with the provisions of its policy entitled
18 “Engagements in Association with Clients.”

19 15. The Commission concluded that Ernst & Young's conduct violated Rule 2-02 of
20 the Commission's Regulation S-X¹² (auditor independence), and also caused PeopleSoft to
21 violate federal securities laws (as further specified in the Decision and the Commission's Order).

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24 11 Mr. Coulson was officed in the national office (not in California) and is not a Board licensee.

25 12. **Regulation S-X (17 CFR §210)** addresses the requisite qualifications of accountants. The *Preliminary*
26 *Note to Section 210.2-01* states that Section 210.2-01 is designed to ensure that auditors are qualified and
27 independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on
28 financial, employment, and business relationships between an accountant and an audit client...Section 210.2-01(b)
sets forth the general standard of auditor independence. The rest of the rule reflects the application of the general
standard to particular circumstances. Section 210.2-02(b)(1) requires that the accountant's report state whether
the audit was made in accordance with GAAS. Further, financial statements filed with the Commission must
satisfy the Commission's requirements where those rules are stricter than GAAS.

1 The Commission also concluded that Ernst and Young's conduct violated Rule 102(e)¹³ of the
2 Commission's Rules of Practice, finding that EY engaged in improper professional conduct
3 because it violated applicable professional standards for auditors (GAAS) by conduct that was
4 both reckless and negligent (under the Commission's standards).

5 16. The Order provided:

- 6 a. Ernst and Young was ordered to cease and desist from committing any
7 violations and any future violations of Rule 2-02 of Regulation S-X (see footnote 11), and from
8 causing any violations and any future violations of the Securities Act and the Securities
9 Exchange Act and associated rules;
- 10 b. Ernst and Young was ordered to disgorge the sum of \$1,686,500, plus
11 \$478,050 in prejudgment interest thereon; and
- 12 c. Ernst and Young was required to retain an independent consultant acceptable
13 to the Commission to work with Ernst & Young LLP to assure the Commission of Ernst &
14 Young's commitment to, and implementation of, policies and procedures that reasonably can be
15 expected to remedy the violations found and result in compliance with the Commission's rules
16 on auditor independence related to business relationships and with GAAS. The consultant is to
17 report to the Commission in writing six months from the date work begins.
- 18 d. Ernst & Young LLP was suspended from accepting audit engagements for
19 new Commission registrant audit clients for a period of six months, commencing on April 26,
20 2004.

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- 22 13. Rule 102(e) [17 CFR §201.102(e)] provides that the Commission may censure a person or deny,
23 temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is
found...(1) Not to possess the requisite qualifications to represent others; or
24 (ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or
(iii) To have wilfully violated, or wilfully aided or abetted the violation of any provision of the Federal securities
25 laws or the rules and regulations thereunder.
(iv) With respect to persons licensed to practice as accountants, "improper professional conduct" under
26 §201.102(e)(1)(ii) means: (A) Intentional or knowing conduct, including reckless conduct, that results in a
violation of applicable professional standards; or (B) Either of the following two types of negligent conduct:
27 (1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards
in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
28 (2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards,
that indicate a lack of competence to practice before the Commission.

1 17. The Commission's Decision and Order, as set forth in paragraphs 8 through 16
2 above, constitutes the suspension of the right to practice before a governmental body or agency
3 within the meaning of Code section 5100(h), establishing cause for discipline of Respondent
4 Ernst & Young's partnership registration under Code section 5101.

5 **SECOND CAUSE FOR DISCIPLINE**

6 **Imposition of Discipline, Penalty or Sanction by the SEC**
7 **[Business and Professions Code § 5100(l)]**

8 18. Complainant realleges paragraphs 8 through 16, above, and incorporates them
9 herein by reference as if fully set forth at this point.

10 19. The Commission's Decision and Order constitutes the imposition of a penalty,
11 sanction, or discipline by the United States Securities and Exchange Commission within the
12 meaning of Code section 5100(l), establishing cause for discipline of Respondent Ernst &
13 Young's partnership registration under Code section 5101

14 **THIRD CAUSE FOR DISCIPLINE**

15 **Independence Violations**
16 **[Board Rule 65/Bus. & Prof. Code § 5100(g)]**

17 20. Complainant realleges paragraphs 8 through 16, above, and incorporates them
18 herein by reference as if fully set forth at this point.

19 21. The certifications, in Ernst and Young's audit reports in the respective years, by
20 its engagement partner, that EY was independent in its audits of PeopleSoft's financial
21 statements, for the fiscal years ending 1994, 1995, 1996, 1997, 1998, and 1999, were contrary to
22 fact and were not supported by EY's audit procedures, constituting violations of Board Rule 65
23 requiring independence.

24 22. Incorporating by reference the matters alleged in paragraphs 20 and 21, cause for
25 discipline of Respondent's license is established under Code sections 5100(g) and 5101 for
26 violations of Board Rule 65 requiring its licensees to be independent in the performance of
27 services in accordance with professional standards.

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1 **OTHER MATTERS**

2 **Disciplinary Considerations**

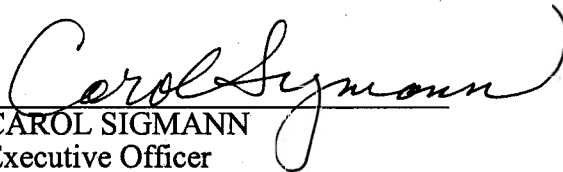
3 23. Commission's Findings Constitute Support for Aggravation of Penalty. The
4 Commission's Decision contains findings regarding EY's conduct which constitute factors in
5 aggravation of penalty under the criteria set forth in the Board's Disciplinary Guidelines, codified
6 at Title 16, Cal. Code Regs. §98 (Board Rule 98). Among those findings are: EY was on notice
7 regarding compliance with the same Commission independence standards it violated in the
8 PeopleSoft matter because of two prior Commission actions; EY's conduct was blatant; the
9 violations occurred over a period of several audit engagements; EY personnel failed to document
10 independence consultations, if such consultations occurred; and, at the time of the hearing,
11 nothing in the record demonstrated EY's willingness to accept the auditor independence rules
12 applicable to business relationships with audit clients.

13 **PRAYER**

14 WHEREFORE, Complainant requests that a hearing be held on the matters herein
15 alleged, and that following the hearing, the California Board of Accountancy issue a decision:

- 16 1. Revoking, suspending or otherwise imposing discipline upon Certified Public
17 Accountant Partnership Registration No. 5413; and
18 2. Taking such other further action as may be deemed proper.

19 DATED: August 30, 2004.

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21 CAROL SIGMANN
22 Executive Officer
23 California Board of Accountancy
24 Department of Consumer Affairs
25 State of California
26 Complainant
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